ACT
PAST PAPER

Diploma in Treasury Management (AMCT)

Unit 4a: Financial reporting, tax and regulation for treasury

November 2024

This is a past paper for Unit 4a of the Diploma in Treasury Management (AMCT)

Based on the syllabus assessed from 1 August 2022.

INTRODUCTION

This past paper has been produced by the Awarding Body at the Association of Corporate Treasurers (ACT) to assist students in their preparation for the Diploma in Treasury Management assessments. It is important to highlight that the answers provided in this paper are not exhaustive and that any other reasonable answers would be awarded marks where necessary in a marked assessment. It contains a past exam for the specified unit as well as past answers. Ideally, students should have completed the majority of their Diploma in Treasury Management studies for Unit 4a before attempting this past paper.

Students should allow themselves 180 minutes to complete the exam plus an additional 15 minutes reading time. They should then review their performance to identify areas of weakness on which to concentrate the remainder of their study time. Although the past exam in this guide is typical of a Diploma in Treasury Management assessment, it should be noted that it is not possible to test every single aspect of the syllabus in any one particular exam.

To prepare properly for the examination, students should make full use of the tuition options where available and read as widely as possible to ensure that the whole syllabus has been covered.

ASSESSMENT TECHNIQUE

This paper is a professional paper that as well as testing theory expects application to practice at a managerial level.

The best way to approach written assessments is to work methodically through the questions. You should not spend too much time on any one question if you are struggling to think of an adequate answer. Remember you can flag any question to come back to later should you want to continue your way through the exam.

When all of the questions have been answered, it is prudent to use any remaining time to go through each question again, carefully, to double-check that nothing has been missed. Altering just one response could make the difference between passing and failing.

Please ensure you show your workings within your answer when prompted as this means there are marks available for the workings out. You will be able to make rough workings on a piece of paper during the exam and on screen should you wish to, however these will not count towards your final mark.

ASSESSMENT INFORMATION AND TEST SPECIFICATION

The Diploma in Treasury Management Units 4A and 4B each have 3 mandatory written questions. The papers will be split into sections A and B and will involve a pre-seen case study for Section A that is released no later than two weeks prior to the assessment date. Each unit exam is worth a total of 100 marks. For the purpose of this past paper the questions follow each case study.

Diploma in treasury management assessment test specification:

Section	Amount of questions	Marks available
Section A	1 case study based question	50
Section B	2 shorter case study based questions	25 marks each
Total	**3**	**100**

Under exam conditions, **3 hours** (180 minutes) is allowed for the Diploma in Treasury Management assessments plus an additional 15 minutes reading time.

When you take your actual exam, you will be sitting online using your own PC/Laptop. You have access to an online scientific calculator, but for the purpose of this past paper, you may use a non-programmable scientific calculator.

In order for you to determine how well you have performed, sample mark schemes are provided after each question. Please note that these are mark schemes only and not model answers. They provide lists of points that are expected to be covered within answers, although the content of your answers must be much more detailed (satisfying the command word used in the question, for example 'analyse'). As with all mark schemes, the content is indicative only, i.e. the lists of points featured are not exhaustive. It is highly likely that there are other perspectives and, provided these are valid and supported fully, marks would be awarded for these in a live exam. There are also references to the relevant Learning Outcomes if you need to revisit the associated material.

SECTION A

1 long form question worth 50 marks based on a pre-seen case study. This question should test knowledge, analysis, application insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level.

Total available for Section A: 50 marks

QUESTION 1: CASE STUDY

Greeting Cards Company (GCC) is a private company headquartered in the US. It manufactures products such as greeting cards, gifts, stationery, home décor items and materials for arts and crafts. In addition to directly selling to individual customers, GCC sells customised products to corporate customers, who then sell these products on to their own customers. GCC has seen strong financial performance in the last ten years and is rapidly expanding to other countries in Europe and Asia. Given its success, GCC is looking to take the company public on the New York stock exchange in the next few years.

Treasury function

GCC Management has recently hired a new treasury director in the US to oversee the treasury function of the group. The new treasury director has been considering the structure of the treasury function. Currently, some subsidiaries have their own treasury personnel while other subsidiaries rely on the treasury team of the head office to execute some of their treasury-related activities.

There is not a clear allocation of responsibilities. For example, some of the newly established subsidiaries that have not yet generated a positive cash flow are looking to borrow funds from external counterparties. Some of these borrowing arrangements are being made by the treasury team in the head office, while others are being arranged directly by the regional finance teams. The treasury director is considering whether to centralise the treasury function across all subsidiaries or hire additional personnel to establish local treasury teams for those subsidiaries that lack one.

Another consideration for the treasury director is identifying ways to improve oversight and controls within the treasury department. This effort is a part of a wider initiative to improve compliance with Sarbanes-Oxley regulations for a future listing on the stock exchange.

The treasury director has noted that treasury personnel in the head office are highly qualified and have experience in planning and executing derivatives, which is crucial for GCC in managing its foreign exposure risks. Collectively, these treasury personnel have experience in many, but not all, of the regions in which GCC operates. The treasury director has also noted that the treasury team at the head office recently implemented a bespoke treasury management system with functionalities including the ability to set up 'payment factories' (the ability to provide payment services to the subsidiaries).

Deferred tax

The newly acquired business in the UK has recently purchased specialised printing equipment for GBP50,000 in the year-ended 31 March 2024. While reviewing the tax and accounting treatment of this purchase as a

part of the quarterly treasury review, the treasury assistant thinks they have found an error. A charge labelled "deferred tax" has been added to the chargeable profit, which has increased the total tax charge. The treasury assistant believes that, without the deferred tax charge, the chargeable profit should be GBP45,542. There is a further deferred tax element on the balance sheet, which has confused the treasury assistant.

The treasury assistant used the following information to calculate the chargeable profit: for accounting purposes, GCC is writing off the cost of the equipment evenly over 12 years. The corporate tax rate in the UK is 25%. The company is entitled to 100% capital allowance under the new capital allowances offer. In the financial year-ended 31^{s} March 2024, this UK subsidiary of GCC made a profit (before tax) of GBP228,000.

Investments in subsidiary

GCC is acquiring a new subsidiary in France which has net assets of EUR8m. The investment structure is proposed to be the same as that of existing subsidiaries in the group. The US-based company, which is the ultimate parent company of the entire group, will invest in this subsidiary through a US-based holding company. The holding company is a wholly-owned subsidiary of the parent company. The parent company will initially borrow EUR8m. The holding company will borrow this amount from the parent company and subsequently invest the EUR8m in shares in the subsidiary in France.

Management believes that this structure mitigates certain operational, tax and legal risks, as well as being efficient in terms of minimising foreign exchange fluctuations in the consolidated statement of profit or loss of the group. The treasury director has been asked for their input on this investment structure. The treasury director does not believe that this is a tax efficient arrangement.

Financial Statement disclosures

The treasury director is reviewing the financial disclosures prepared by the treasury team for the group financial accounts for the year-ended 31 March 2024. The treasury director has noted the following areas of concern while reviewing the IFRS 7 financial instruments disclosures:

1. all financial assets and liabilities appear to have been correctly disclosed, except for long-term borrowings. These have been left out of the disclosure entirely. This appears to be an oversight. Further, the treasury director recalls an incident where a loan repayment of USD2.5m was paid late due to a technological failure in the payments system. An urgent manual payment had to be made the next day when the bank followed up on the missed payment. The treasury director cannot find details of this incident within the disclosures prepared by the treasury team
2. there is some qualitative narrative included within the IFRS 7 disclosure regarding various risks being faced by GCC. However, this appears to be identical to the IFRS 7 disclosure in the prior year's financial statements. The treasury director is aware of the following major risk that GCC is currently facing which should perhaps be included. The main corporate customer of GCC has been facing financial difficulties and there are rumours that it may become insolvent. This has been reported extensively by various media outlets. GCC had an outstanding trades receivables balance of USD15 million with this customer at the end of the financial year ending 31 March 2024. Many of the invoices within this balance were past due at that time. The treasury director is concerned about the recoverability of the outstanding balance.

ISDA

GCC uses hedging to manage its foreign exchange risks. GCC uses over-the-counter derivative instruments such as foreign currency forwards and swaps for this purpose. These are used both in the US and abroad.

GCC currently trades these derivatives with two counterparties, only one of which is based in the US. The treasury director is considering entering into contracts with additional counterparties to spread the credit risk to GCC. The treasury director has entered into discussions with several banks to identify suitable ones.

The treasury team has been working on draft ISDA documentation in relation to these contracts. GGC's management believes that the treasury team should focus on other tasks that add more value to the business.

In reviewing the draft ISDA documents, the treasury director has noted that one of the banks has requested a break clause to be included within the documentation. This has surprised the treasury director as GCC has always maintained a strong credit rating and there appears to be no indication of the credit rating deteriorating. The treasury director has not come across a break clause before and needs to consider whether to accept this term.

QUESTION 1

a.	Analyse the potential advantages and disadvantages for GCC of establishing a centralised treasury function.	10 marks
b.	With regards to the purchase of specialised printing equipment: i) calculate, showing your workings, the chargeable profits with and without the deferred tax charge ii) discuss why deferred tax arises, including the balance sheet element. Examine the tax consequences of the proposed arrangement for investment in the French subsidiary.	5 marks 6 marks
c.	Examine the tax consequences of the proposed arrangement for investment in the French subsidiary. Within your answer you are required to recommend and justify a tax-efficient arrangement.	11 marks
d.	Discuss the IFRS 7 financial reporting disclosures that GCC's treasury should include in its financial statements.	9 marks
e.	Discuss the break clause requirement requested by the bank within the ISDA documentation. Include in your discussion why ISDA documentation is necessary.	9 marks
		Total: 50 marks

Mark scheme

Q1a

Reasons for a centralised treasury function: • Synergy of expertise and improved control: GCC uses derivatives to manage risks. Having a centralised function will allow better control over decision making regarding the derivatives, as well as allowing select few members of finance with expertise and experience in derivates to make these decisions. Any risk of rogue dealings by subsidiaries will also be minimised. It will enable the finance team to focus on finance-related activities, rather than treasury functions.	2 marks

- Cost savings: GCC will not need to hire additional staff in various locations. Further, with regards to derivatives commissions on outside deals through increased buying power.
- Single financial status: When bankers, investors or creditors provide funds to an organisation, it is often based on an assessment of the continuing financial health and viability of the entire organisation. Even if the funds are being provided to a subsidiary, it is normal practice to assess subsidiaries as extensions of the parent organisation. Therefore, as all of GCC's subsidiaries are likely to be assessed as a single entity for the funds it intends to borrow, it makes a lot of sense to manage the finances centrally.
- GCC has recently implemented a new state-of-the-art Treasury Management System which will make centralisation of certain activities possible, such as payment factories.
- Regulation: GCC is working to improve governance to maintain compliance with Sarbanes-Oxley. Centralisation will allow for a greater control over treasury activities and improve compliance with a consistent treasury policy consistent with the Board appetite for risk.

2 marks

1 mark

1 mark

1 mark

Disadvantages of a centralised treasury function:

- First, the trend towards identifying profit centres within an organisation implies that those in charge of these units should also be in charge of their finances. By centralising the organisation, the profit centre manager cannot be said to operate a self-contained business and, hence, to be entirely accountable for its performance. Local GCC teams may be dis-incentivised from reporting risks such as foreign exchange risks that could be relevant to derivatives.
- Treasury personnel in the central treasury function of GCC do not have experience in many of the regions in which GCC operates. This could be a challenge in countries where foreign exchange regulations restrict international transfers.

2 marks

1 mark

Max mark: 10

Q1b

i)

	GBP	Notes
Profit	228,000	
Add back: depreciation	**4,167**	50,000/ 12 years
Deduct capital allowance 18%	**(50,000)**	50,000 x 100%
Chargeable profits	**182,167**	
Corporation tax at 25%	**45,542**	
Effective tax rate	**20.0%**	45,542/228,000
Accelerated capital allowance	**45,833**	50,000-4,167
Deferred tax at 25%	**11,458**	45,833 x 25%
Total tax charge	**57,000**	45,4522 + 11,458
Effective tax rate	**0.25**	57,000/228,000

½ mark to be awarded for each number in **bold**
5 marks max

ii)	Deferred tax arises where there is a timing difference between the period in which an item is booked for accounting purposes and the period in which it is recognised for tax purpose, or when a standardised basis of relief, e.g. capital allowances, replaces an accounting measure, e.g. depreciation. As the standardised rate of tax-allowable depreciation (capital allowance at 18%) is greater than the accounting rate, the profit chargeable to corporation tax is lower than the accounting profit in the first period, and the company's effective rate of tax (24.5%) is less than the actual rate of 25%. However, the tax and accounting depreciation will equalise over time. After a few years, the chargeable profit will exceed the accounting profit and the effective rate of tax will be greater than the actual rate of 25%. Deferred tax is calculated on the accelerated amount and is used to equalise the effective rate of tax in the income statement. The cumulative amount of deferred tax arising from all temporary differences is shown as a liability or asset on the company's balance sheet.	2 marks 3 marks 1 mark **Total marks: 11**
	Q1c	
	As the parent company of GCC group prepares its accounts in USD, the EUR8 million loan liability will give rise to foreign exchange differences by reference to movements in the USD/EUR exchange rate. There will be an equal and opposite FX movement in the group accounts when the EUR8 million net assets are translated into USD and consolidated. Since tax is charged on an entity and not group level, the parent company will be taxed on FX movements on the liability under the loan relationship rules. The FX movements on the net assets and its tax impact, however, will be reflected in the holding company's accounts. Without any special relief, the group is subject to tax on FX gains and losses on the loan. GCC can make this transaction more tax efficient using 'matching' as per the Disregard Regulations. This removes currency-related movements on loan relationships and derivative contracts from the charge to tax, if they are acting as a net investment hedge. The FX movements are only brought into charge to tax if the company subsequently incurs a taxable capital gain or loss on disposal of the hedged shares. The loan liability must be held in the holding company. This can be achieved by either the holding company entering the loan relationship itself, or by arranging a USD/EUR cross currency swap between the parent and holding company.	2 marks 3 marks 3 marks 3 marks **Total marks: 11**
	Q1d	
	IFRS 7 requires certain balance sheet disclosures. This includes disclosing all categories of financial assets and financial liabilities. Currently, long-term borrowings have not been included in the disclosure.	1 mark

Any defaults and breaches must be included. GCC failed to make a repayment of USD2.5 million to a lender due to a technological issue with its legacy payment system. This must therefore de disclosed.	1 mark
GCC need to include disclosures on credit risk, liquidity risk and market risk. The current narrative around credit and liquidity risks seems incorrect. The main corporate customer of GCC is facing financial difficulties. GCC had an outstanding trades receivables balance of USD15 million with this customer at the end of the financial year. Many of the invoices within this balance were past due at the time. There is a credit risk that this customer may not be able to settle these trades. This could also lead to liquidity risk for GCC. It must therefore update the narrative from the prior year to include the following: These disclosures include: • a narrative description of the exposure to risk and how it arises • the objectives, policies and processes for managing the risk, including methods used to measure the risk • any changes from the prior period.	2 marks 3 marks
The standard also requires information about credit quality of financial assets including an analysis of the age of financial assets that are past due as at the reporting date but not impaired. This must also be reflected for the credit risk being faced due to the corporate customer facing financial difficulties.	2 marks
	Total marks: 9

Q1e

ISDA documentation has the benefits of cost management, reducing risk of disputes and also allowing for faster identification and resolution of disputes.	2 marks
Users of such Master Agreements benefit not only from the ease of documenting multiple transactions under a single agreement, but also from an ability under the laws of many countries to net exposures under those transactions. This substantially reduces potential credit exposures and related risks and administrative costs. An ISDA Master Agreement is a very widely used standardised contract between counterparties trading OTC derivatives. As GCC is planning to use OTC hedging products, it can use an ISDA master agreement, under which a range of transactions can be documented.	3 marks
The ISDA Master Agreement acts to reduce pre-settlement risk by defining each party's right to terminate transactions entered into under the agreement, using the concept of events of default which include, but are generally not limited to, insolvency.	1 mark
The bank has requested a break clause to be included within the ISDA documentation. The discount rate used to value future cashflows depends on the credit standing of the counterparty. The present value of future cashflows due from a corporate to a bank under a swap agreement would fall if the corporate's credit position was to deteriorate, leading to an accounting loss for the bank. In	3 marks

	such circumstances, the bank could invoke a break clause and renegotiate the swap on less favourable terms for the corporate. Such clauses are unhelpful for corporates and should be resisted by GCC. *This mark scheme is not exhaustive – all valid points within answers will be awarded marks.* **Syllabus refs: LO16, LO17, LO18 and LO19**	**Total marks: 10**
		Total: 50 marks

SECTION B – 50 MARKS

2 longer form questions, based on mini case studies, of which both are compulsory (2 x 25 marks). Questions should test knowledge, analysis, application insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level and as would therefore be expected, candidates need to be able to synthesise knowledge from different elements of the syllabus rather than be tested on discreet areas.

QUESTION 2: CASE STUDY

Good Food Limited (GFL) is a catering business based in the UK that delivers healthy frozen meals directly to customers' homes. The business started in 2015 and has seen a rapid increase in demand in the last two years. It earned revenue of GBP2m in the financial year-ended 31 March 2024. GFL plans to expand internationally in the next two years.

Cash management

Until recently, the finance team handled cash management. GFL's management team has now hired dedicated treasury personnel to oversee cash management. The management team hopes this will help resolve the issues discussed below.

GFL operates a fairly simple banking structure. Its cash is held in a business account with a local, well-known bank. This account is not interest bearing. Operational payments and receipts are made from this account.

For simplicity, the finance team of GFL has so far tracked collections and payments manually on spreadsheets. This has had the additional benefit of cost savings by not having to purchase a technological solution. As the business has grown, the team has struggled to maintain accurate records. As a result, there have been instances of late payments, resulting in conflicts with certain suppliers. There have also been instances where overdue receivables have gone unreported and have not been followed up on for several weeks beyond their due date.

During the quarter-end review process, treasury has noted that despite an increase in revenue by 6% from the previous quarter, the cash balance has remained largely the same at around GBP400,000. During the same period, trade receivables have increased disproportionately by 10%.

Further, treasury has noted a difference of GBP2,809 between the cash balance shown on the balance sheet and the bank statement of the main bank account. There is no supporting explanation or documentation for this discrepancy.

In the coming months, GFL's management team is planning spending on equipment and premises that would help expand the business further. This expenditure is likely to be in the region of GBP100,000. Treasury has noted that there are currently no borrowing facilities in place. There appears to be no formal cash-flow forecast in place either.

Environmental, social and governance (ESG) reporting

GFL's management team is aware of the company's responsibility towards the communities within which it operates. The management team strives to use sustainable packaging for the products it delivers and opts for low carbon emission delivery services using electric vehicles. Delivery drivers are paid fair wages and given appropriate holidays and sick leave. Produce suppliers are selected carefully to ensure sustainability of ingredients. Contracts with suppliers ensure fair wages.

There has been some concern over social media regarding data protection as one of GFL's competitors had an IT breach resulting in the competitor's customers' sensitive data, including addresses and payment information, being leaked on the internet. GFL is working to improve its own IT systems to ensure the security and confidentiality of the customer data it holds.

GFL's financial statements do not currently have an ESG reporting section. Treasury has recommended that GFL includes ESG reporting in the next set of financial statements, especially given the positive publicity it could gain from disclosing the practices mentioned above.

QUESTION 1

a.	Discuss the key risks GFL is exposed to regarding its cash management. Within your answer you must recommend and justify measures that GFL can adopt to mitigate these risks.	16 marks
b.	Discuss the importance of ESG reporting to GFL. Propose relevant metrics to be included in GFL's annual report under each of the headings of environmental, social and governance (ESG) commitments.	9 marks
		Total: 25 marks

Mark Scheme

Q1a

GFL's accounts are not interest bearing. Bank account structure is a part of cash management, and therefore the treasury function is responsible for structuring bank accounts to maximise interest earned. GFL should consider establishing relationships with banks and exploring use of short-term investment products to earn interest on surplus cash.	1 mark
Maintaining efficient collections and payments systems forms part of cash management and therefore falls within the responsibilities of the treasury division. Current processes are manual and inefficient. This makes them prone to error. Treasury should consider implementing TMS (treasury management system) to manage these processes.	2 marks

Trade receivables have increased, showing that revenue earned is not being collected, owing to the poor manual collection process in place. Uncollected revenue partly explains why cash balance hasn't increased in line with revenue.	2 marks
GFL has unexplained reconciling items of GBP 2,809 in its cash balance at month-end. Lack of reconciliation puts GFL at risk of missing errors or fraud. Effectively reconciling these items will help GFL: • Note their clearance on a timely basis. • Encourage the investigation and resolution of any unexplained items.	3 marks
GFL should reconcile actual and accounting cash balance every month-end. Reconciling items between the actual cash balance and the accounting cash balance will include: • payments and receipts in the bank balance, not yet recorded in the accounting balance • items in the accounting balance, not yet in the bank balance.	3 marks
GFL should prepare forecasts of actual cash at the bank and accounting balances.	1 mark
GFL should consider procuring short-term cost-effective credit facilities and an overdraft facility. This is particularly important in the context of planned expenses of GBP100,000 when cash collection is fairly poor. GFL is also facing the risk of overtrading if it does not improve its cash management and cash inflow.	2 marks
GFL needs to have a cash flow forecast and budgets in place to manage liquidity. This will help identify funding requirements, especially given that it intends to scale up business and expand internationally. GFL needs to put in place three time 'horizons' for forecasting: • short-term: today up to between 30 days and three months. The forecast is by day and by week. • medium-term: from one to three months up to one year, where the forecast is by month. • long-term: where the forecast is for one or more years (generally mirroring the length of the organisation's strategic plan).	4 marks **Total marks: 16**

Q1b

Global sustainability reporting standards are necessary because: • climate change and the SDGs require a global approach. • businesses have global value chains, face global risks, and access capital from global investors. • investors, companies and other stakeholders benefit from a common language for sustainability reporting standards, facilitating comparisons.	4 marks
Environmental: direct, indirect (owned) and indirect (not owned) emissions. GFL should include quantitative and qualitative disclosures on relevant issues such as recyclability of packaging used in the products delivered, impact of carbon emissions on deliveries and environmental impact of ingredients sourced.	2 marks

	Social: This should include quantitative and qualitative disclosures of fair wages provided to delivery drivers and produce suppliers. Governance: Disclosures around data privacy protections *This mark scheme is not exhaustive – all valid points within answers will be awarded marks.* **Syllabus refs: LO16 and LO20**	2 marks 1 mark **Total marks: 9**
		Total: 25 marks

QUESTION 2: CASE STUDY

Sports Clothing & More (SCM) is a sports apparel and equipment company, headquartered in Germany. SCM operates in various countries across Europe and Asia as well as in the USA, Canada and Brazil. SCM sources high quality raw materials from suppliers all over the world and manufactures most of its products in Germany. SCM earned revenue of EUR35m in the financial year-ended 31 December 2023.

Foreign exchange (FX)

SCM earns revenue in various currencies, with the largest amounts earned in EUR, USD and GBP. SCM sources its raw materials from different countries and receives invoices in various currencies. The invoices are settled by the parent company in Germany. Its largest suppliers are based in India and USA, who invoice in INR and USD respectively. SCM pays its international invoices in foreign currency by converting its EUR. SCM is not using FX hedging currently. The EUR bank account incurs bank charges while paying these international invoices. Further, SCM's bank applies its own FX rates in converting the payments from EUR into the payment currency.

SCM has subsidiaries in all the countries in which it operates. SCM's subsidiaries present their financial statements in the currency of the country in which they are based. The consolidated group accounts are presented in EUR.

SCM has long-term borrowings of EUR100m on its balance sheet. The consolidated group accounts are subject to covenants imposed by the lenders. These covenants include certain financial ratios, such as earnings per share, quick ratio and return on assets. There are no FX carve outs in place. FX carve outs disregard the effects of foreign exchange rate fluctuations on financial ratios. Not having these in place means that the financial ratios are fully subject to changes in foreign exchange.

Tax

One of SCM's subsidiaries, based in Hungary, is having liquidity issues and has reached out to headquarters for assistance. SCM is considering several options. These include:

- purchasing new shares issued by the subsidiary
- obtaining a loan from a bank where the subsidiary will be the counterparty, or
- the parent company to lend the funds under an intercompany loan arrangement.

Treasury is aware that this subsidiary is required to maintain a maximum debt to equity ratio of 2.5, according to local tax regulations.

SCM's parent company has intercompany loan arrangements with several of its subsidiaries. The parent company is subject to a high corporation tax rate of 29.9%. This is higher than almost all the subsidiaries to which the loans have been extended. These intercompany loans incur interest in the range of 5% to 12% per annum, depending on the intercompany loan agreement. Interest payments are made quarterly and are subject to withholding tax.

Some of SCM's subsidiaries had reported losses in previous years. Treasury has noted that these losses have not been used to shelter taxable profits from tax in the current year.

SCM's management team has been made of aware of issues with non-compliance in certain subsidiaries. Corporation tax returns have been filed late consistently, leading to fines and penalties. This appears to be due to staff shortage and high workload.

QUESTION 2

a.	Analyse the key issues faced by SCM in relation to the reporting of its currency values in its financial statements.	7 marks
b.	Discuss the benefits and risks for SCM of using foreign exchange hedging to manage foreign currency risks and how these hedges may impact financial reporting.	7 marks
c.	Assess the current tax issues faced by SCM in relation to the funding of the subsidiaries. Within your answer you are required to recommend and justify relevant solutions.	11 marks
		Total: 25 marks

Mark Scheme

Q2a

Please note that candidates are not to be penalised for not specifically stating the terms "transaction risk" nor "translational risk" listed below.	
Transaction loss – unfavourable movements in FX rates between date of invoice and date of settlement with suppliers paid in foreign currencies can lead to transaction losses.	1 mark
SCM has suppliers internationally who invoice in various currencies. SCM is incurring bank charges and unfavourable FX rates by settling the invoices from the EUR account. SCM should consider hedging.	1 mark
Translation loss: financial statements of foreign subsidiaries will need to be translated to EUR for consolidation into group financial statements. Assets and liabilities are translated at the closing rate and amounts in the income statement are translated at rates applicable on the dates of the transactions or using an average rate for the period. The resulting exchange differences will be recorded in OCI.	3 marks
As suppliers invoice in their own currencies, SCM has a trade payable balance consisting of a mix of currencies. Any monetary items denominated in currencies other than EUR in the parent company's accounts will have to be revalued or translated into the organisation's functional currency of EUR for the purposes of the period-end balance sheet, using the period-end FX rate. The resulting exchange differences will impact the income statement, effecting the overall profit/ loss.	2 marks
Similarly, unfavourable movements in FX rates may cause EBITDA in a particular currency to be of lower value, on translation, than anticipated.	1 mark
If FX losses have an adverse effect on the financial statements this may, in turn, lead to a breach in any financial covenants in place with its lenders. Further, it	1 mark

adversely affects the credit rating. This could impact the entities' ability to obtain credit in the future.	**Total marks: 7**

Q2b

Hedging is the process of entering into an offsetting position (the hedging instrument) to neutralise the effect of possible changes in the future value of, or cashflow associated with, an exposure (the hedged item). For example, to manage the risk that USD may appreciate in the future when trade payables fall due, SCM could enter a forward foreign exchange contract and agree with a bank that SCM will buy USD for EUR at a fixed rate. As such, whatever happens to the USD/EUR FX rate until the time of settlement, the fluctuation in value of the EUR payable will exactly be compensates by the fluctuation in the value of the forward FX contract.	3 marks
SCM should be aware that accessing FX markets to hedge FX risks would expose SCM to further risks. The deals would expose SCM to operational, settlement and counterparty risk. Revaluation of the derivatives would impact the reported earnings figures.	2 marks
In the absence of hedge accounting, the change in the market value of a forward FX contract taken out to economically hedge future FX purchases must be shown in the income statement, whilst the change in the value of future purchases remains unrecognised. This creates accounting income volatility. Hedge accounting allows an entity to reflect risk management activities in the financial statements by matching gains or losses on financial hedging instruments with losses or gains on the risk exposures they hedge.	3 marks **Total marks: 7**

Q2c

Interest on a loan is typically a deductible expense for tax purposes if the entity has made a taxable profit. Dividends payable on shares, however, are not normally tax deductible. Where additional liquidity is required, SCM's subsidiaries could benefit from raising funds through loans instead of issuing shares. If, however, the subsidiary is loss making, it will not benefit from the deduction, so issuing shares could potentially be more beneficial. If a loan is to be obtained, it is important for the group to consider the tax rates in each jurisdiction before deciding whether it would be more beneficial for the parent or the subsidiary to obtain the loan. Other factors to consider are whether costs may be carried forward or not for tax relief and timing of cash flows (paying tax and getting relief).	4 marks
Another consideration with a loan to the foreign subsidiary is that thin capitalisation rules may be breached, since a maximum debt to equity ratio of 2.5 is required. As per the local tax rules, the subsidiary may lose the opportunity to deduct interest expense from its chargeable profit. SCM needs to monitor its debt to equity ratio and ensure that it complies with the thin capitalisation rules.	2 marks

There is negative tax arbitrage on borrowing arrangements between subsidiaries. Certain subsidiaries have borrowed from the parent company that has a higher tax rate of 29.9%. The parent company is having to pay tax at 29.9% on interest income while the borrowers are saving tax on interest expense at a lower rate. SCM needs to review these arrangements and consider settling loans to reduce the tax liability.	2 marks
SCM is suffering withholding tax on interest paid on intercompany loan payments. This will have a negative impact on its cash flows. The interest policy on its intercompany loans must be reconsidered to optimise the interest rates and payment terms, ensuring compliance with transfer pricing rules to minimize the withholding tax impact.	1 mark 1 mark
SCM has not been utilising tax losses from previous periods. In some countries, these can be carried forward for an indefinite period. SCM should consider applying these to gain from tax relief in the current and future periods.	2 marks
There have been instances where tax returns have been filed late. This could lead to interest and penalty charge, affecting the cash flow negatively. SCM should ensure it has appropriate processes and controls in place, as well as ensuring sufficient training is provided to staff, to prevent instances of late filings.	1 mark
The above could lead to reputational damage as the public does not support businesses that are thought to be using techniques to reduce the amount they contribute to the public purse. Consequently, some investors may not feel comfortable funding those companies. *This mark scheme is not exhaustive – all valid points within answers will be awarded marks.* **Syllabus refs: LO16 and LO18**	**Total marks: 11**
	Total: 25 marks

Published in December 2024 by
ACT (Administration) Limited
10 Lower Thames Street
London
EC3R 6AF
www.treasurers.org

Copyright © ACT (Administration) Limited 2024

All rights reserved. Except as permitted under current legislation you may not photocopy, store in a retrieval system, publish, perform in public, adapt, broadcast, transmit, record or reproduce in any form or by any means or medium any part of this work without ACT (Administration) Limited's permission.

Nothing in this publication should be taken as constituting professional advice. Although we have made every effort to ensure that the contents are correct at the time of publication, ACT (Administration) Limited makes no warranty that the information in this publication is accurate or complete and accepts no liability for any loss or damage suffered by any person acting or refraining from acting as a result of anything in this publication.